

October 2, 2006

HONORABLE MAYOR AND CITY COUNCIL:

In accordance with Section 701(F) of the San José City Charter, I hereby transmit to you a report describing the financial status of the City as of the end of the 2005-2006 fiscal year. As specified in the City Charter, the focus of the City Manager's Annual Report is a comparison of actual revenue collections and expenditures to projections included in the City's budget.

The Annual Report document is organized into three sections: (1) Letter of Transmittal, (2) 2005-2006 General Fund performance, and (3) 2005-2006 Special/Capital Fund performance.

The Report also includes a number of recommended actions revising both the 2006-2007 Adopted Operating and Capital budgets. These actions also generally fall into three categories: (1) rebudgeting prior year funds for projects not completed last year; (2) reconciling budgeted Beginning Fund Balance amounts in various funds, including the General Fund, with the actual results; and (3) actions that based on more recent information are necessary to revise the 2006-2007 budget to correct technical problems, complete City Council direction and/or address newly emerging, urgent budget issues.

This Letter of Transmittal is intended to provide the City Council with summary information regarding the contents of the Report. Included is an overview of the 2005-2006 General Fund financial performance; an analysis of the potential impact of that performance on the current year budget; a discussion of the financial status of selected other City funds; and descriptions of recommendations for revisions to the 2006-2007 Adopted Budgets in a number of funds, including the General Fund.

RECOMMENDATION

It is recommended that the City Council:

- Accept the 2005-2006 City Manager's Annual Report of the Finances of the City of San José, in compliance with City Charter Section 701 (F).
- Adopt Appropriation Ordinance and Funding Sources Resolution amendments in various operating and capital funds to implement 2005-2006 Annual Report recommendations, including appropriate technical adjustments, as detailed in Section III (Appropriation/Clean-Up Adjustment Actions) of this report.

RECOMMENDATION (CONT'D.)

- Approve position actions in the Airport, Fire, Housing, Planning, Building and Code Enforcement, and Parks, Recreation and Neighborhood Services Departments, and the Offices of the City Auditor, City Clerk, and City Manager, for a net addition of 10.5 positions also described in Section III of this report.

OVERVIEW

2005-2006 was a turnaround year for the City, in which we experienced a return to modest revenue growth in most of our major revenue sources, following four years of relatively dismal economic performance. Also, almost without exception, revenues and expenditures performed at or better than budgeted levels, and as discussed later in this report, this resulted in budgetary surpluses in several funds, including the General Fund. Conservative revenue estimates and successful budgetary controls were a major contributor to this success. In a positive sign for the prospects for the economic future, a significant portion of the overall General Fund revenue growth was experienced by our two largest revenue sources, both of which have a direct relationship to economic health -- Property Taxes and Sales Taxes. Relatively healthy growth was also experienced, however, in a number of other revenue sources, including one other source which is often an economic leading indicator, the Transient Occupancy Tax.

Even with this improved performance, however, there of course remain areas of concern. Recent economic news indicates, for example, that the long expected cooling of the housing market has definitely begun locally, and in fact, across the country. Energy prices, although dropping from the highs of a couple of months ago, continue to negatively impact growth. And given the volatility of the energy sector and particularly its exposure to instant impacts of instable conditions in many oil producing regions of the world, energy spikes will remain a threat. In general, in fact, for some months the national economy has shown, and continues to show signs of cooling. Locally, although conditions have stabilized, there is no indication of major new economic activity, and to date only a very modest level of growth in jobs, far below the level necessary to begin making up for the jobs in the wake of the dot com bust. The economists take on these various mixed economic signals varies. The latest UCLA Anderson forecast update, for example, predicts that the current housing decline will have a negative impact on both the national and State economies, but does not believe that this will result in a return to recessionary conditions.

On an overall basis, our review of 2005-2006 year-end fiscal results confirms that we have emerged from one of the most severe economic downturns experienced in decades in a stable financial condition, although as we are all aware, this stability has come at a severe cost -- reductions in vital core City services almost across the board. The 2005-2006 fiscal year also revealed a return to a moderate growth pattern, which, although far below that experienced in the heady years of the late 1990s, is a welcome change from the conditions experienced in the four prior years. Thanks to our strong financial practices, the General Fund not only ended yet another tough year in the black, but also closed the year with a small budgetary surplus.

OVERVIEW (CONT'D.)

Contributing strongly to the 2005-2006 year end results was the continuation of Council directed cost containment strategies. These included mid-year budget reductions (totaling \$6.0 million in the General Fund and placed in a reserve for 2006-2007 budget balancing purposes), the continuation of a hiring freeze (first imposed in 2001), and continued controls on a number of non-essential expenditure categories, including those related to overtime, marketing, and technology purchases. In total in the General Fund, net of rebudgets, year-end expenditure savings of \$42.5 million were achieved from budgeted estimates. After adjusting for grant and reimbursement related appropriations not expended in 2005-2006, but rebudgeted to 2006-2007, net expenditures ended the year approximately \$28.9 million, or 3.7%, under budgeted estimates.

On the revenue side of the General Fund, as always, the estimates were formulated conservatively, and receipts were closely monitored and reported to the City Council through the Monthly Financial Reporting process and the Mid-Year Budget Review. In 2005-2006 overall General Fund revenues grew by \$80.8 million or 11.8% from the prior year. As a result of the active management of our revenue estimates, the General Fund in 2005-2006 ended the year very close to the projected total, finishing on a gross basis approximately \$10.0 million below the budgeted estimate. Again, after adjusting for the grant and reimbursement related revenues not received in 2005-2006, but carried over to 2006-2007, it can be seen that revenues actually ended the year within 0.5%, or \$3.6 million above the budgeted estimate used for fund balance purposes. Given our stated desire to end the year slightly (1%-2% above budgeted levels), the Administration considers this performance to be a successful outcome, particularly given the total size of General Fund revenues (\$763 million).

The overall result of this performance was that the General Fund ended the year in a positive position, with a fund balance surplus (from budgeted levels) of \$34.6 million. After netting out the portion of this fund balance necessary to rebudget to the 2006-2007 year, a surplus of approximately \$19.6 million remains.

A significant portion of that balance (\$13.1 million) is recommended in this document to be used to make a series of budget revisions to address funding issues that have emerged since the 2006-2007 budget was approved. The remaining amount, \$6.4 million, per Council policy is recommended to be placed into reserve to address the projected 2007-2008 General Fund budget shortfall.

The components and recommended disposition of this fund balance is explained in greater detail later in this transmittal.

In summary, this analysis of the City's final 2005-2006 fiscal performance indicates that our policy choices and management strategies implemented to preserve the fiscal soundness of the City in the face of the very tough fiscal climate were successful. With only a very few exceptions, expenditures and revenues occurred within budgeted levels, and relatively stable fund balances remained in all City funds at year end.

OVERVIEW (CONT'D.)

It must be remembered, however, that all of our forecasts for future year prospects continue to show that revenue growth is not going to keep up with current program cost growth, much less be adequate to fund the many unbudgeted needs facing the City. This unfortunately means that we will need to continue to face very tight budgetary times, even with a return to more normal revenue growth patterns, and that the City will continue to face budget deficits and tough spending decisions for the foreseeable future.

2005-2006 GENERAL FUND PERFORMANCE OVERVIEW

As discussed above, the analysis of final 2005-2006 year-end financial data indicates that the City's General Fund ended the year well within budget, and in fact, the 2005-2006 General Fund Ending Fund Balance of \$209.5 million was approximately \$34.6 million above the fund balance level estimate approved as part of the 2006-2007 Adopted Budget.

Table 1 (below) describes the three principal components of the \$34.6 million fund balance surplus. On a gross basis, the surplus amount was composed of \$0.4 million in lower than anticipated liquidation of carryover encumbrances, a \$10.0 million shortfall in revenue collections, \$42.5 million in additional expenditures/transfers savings, and \$2.5 million savings from the estimated Ending Fund Balance Reserve. It should be noted, however, that after adjusting for net zero grant and reimbursement related revenues and expenditures not received or expended in 2005-2006, but carried over to 2006-2007, a more accurate depiction of the revenue variance was a surplus of \$3.6 million, and the expenditures variance was a surplus of \$28.9 million.

A significant portion of additional fund balance (\$15.0 million) is recommended to be reinvested or rebudgeted as a part of this report to complete previously approved departmental or City-wide projects, and to comply with the current policy regarding Development Fee Program revenue where a total of \$3.0 million in Development Program fee proceeds which exceeded program costs is to be placed in the existing Fee Program reserves as a result of the year-end reconciliation process comparing revenues and expenditures. An additional total of \$13.1 million is recommended to be used for a series of adjustments to address mistakes discovered in the 2006-2007 Budget since it was adopted, and/or provide for additional high priority funding needs that have been identified since the June approval of the budget. Finally, as noted above, the surplus fund balance monies left after rebudgeting and recommended clean-up actions (\$6.4 million) is recommended, per Council policy, to be used to establish a 2007-2008 Future Deficit Reserve. The specific adjustments proposed are discussed in greater detail elsewhere in this document.

2005-2006 GENERAL FUND PERFORMANCE OVERVIEW (CONT'D.)

Table 1
Results of Operations in the General Fund
For the Year Ended June 30, 2006
(\$000's)

	1	2	3	4	5
<i>Sources</i>	Revised Budget	Year-end Estimate	Budgetary Basis Actual	Variance 1 to 3	Variance 2 to 3
<i>Beginning Fund Balance</i>	187,817	187,817	187,817	-	-
<i>Liquidation of Carry- over Encumbrances</i>	-	1,138	772	772	(366)
<i>Revenue *</i>	772,790	772,790	762,768	(10,022)	(10,022)
<i>Totals</i>	<u>960,607</u>	<u>961,745</u>	<u>951,357</u>	<u>(9,250)</u>	<u>(10,388)</u>
<i>Uses</i>					
<i>Expenditures *</i>	809,948	777,919	735,432	74,516	42,487
<i>Transfers</i>	6,432	6,432	6,432	-	-
<i>Reserves</i>	144,227	2,497	-	144,227	2,497
<i>Totals</i>	<u>960,607</u>	<u>786,848</u>	<u>741,864</u>	<u>218,743</u>	<u>44,984</u>
<i>Available Ending Fund Balance</i>	<u>N/A</u>	<u>174,897</u>	<u>209,493</u>	<u>209,493</u>	<u>34,596</u>

- * After adjusting for a net-zero \$13.6 million of grant and reimbursement related revenues and expenditures not received or expended in 2005-2006, but carried over to 2006-2007, the revenue variance resulted in a surplus of \$3.6 million and the expenditures variance actually totaled \$28.9 million.

2005-2006 GENERAL FUND PERFORMANCE OVERVIEW (CONT'D.)

Table 2 below compares the City's financial performance in 2005-2006, with the financial performance of the prior year (2004-2005).

Table 2
General Fund
Comparison of Year-End Actuals With Prior Year
(\$ in millions)

<i>Sources</i>	2004-2005	2005-2006	Change	% Change
<i>Beginning Fund Balance</i>	176.6	188.6	12.0	6.8%
<i>Revenue</i>	682.0	762.8	80.8	11.8%
<i>Total Source</i>	858.6	951.4	92.8	10.8%
<i>Uses</i>				
<i>Expenditures</i>	686.4	735.5	49.1	7.2%
<i>Transfers</i>	6.1	6.4	0.3	4.9%
<i>Total Use</i>	692.5	741.9	49.4	7.1%
<i>Available Ending Fund Balance</i>	166.1	209.5	43.4	26.1%

As shown in Table 2, 2005-2006 General Fund revenues of \$762.8 million represented an increase (11.8% or \$80.8 million) from the prior year's collection level. The size of this increase is somewhat misleading however, as the 2005-2006 year contained a half year (\$10 million) collections of a new revenue source which did not exist in the prior year (the Emergency Communications System Support Fee), and two large one-time revenue deposits totaling \$14.6 million from the FMC land purchase transaction and developer contributions for the Coyote Valley Specific Plan. When adjusted for these items, a more accurate year to year growth comparison is approximately 6.0%.

The increase from the prior year reflected the combined performance of General Fund revenue categories. Increases from the prior year level were experienced in a number of sources: Property Tax, up 15.6%; Sales Tax, up 5.4%; Transient Occupancy Tax, up 20.0%; Franchise Fees, up 9.0%; Utility Tax, up 3.3%; Licenses and Permits, up 3.7%; Fines, Forfeitures, and Penalties, up 8.4%; Use of Money and Property, up 45.4%; Revenue from the Federal Government, up 141.6%; Other Revenue, up 137.4% (reflecting one-time revenues from the FMC land purchase transaction and proceeds from developers for the Coyote Valley Specific Plan); and Transfers and Reimbursements, up 13.7% (primarily due to the annualization of the Emergency Communications System Support Fee revenue). These increases were somewhat offset, however, by lower receipts in the remaining revenue categories: Revenue from Local Agencies, down 5.0%; Revenue from the State of California, down 14.1%; and Departmental Charges, down 0.8%.

2005-2006 GENERAL FUND PERFORMANCE OVERVIEW (CONT'D.)

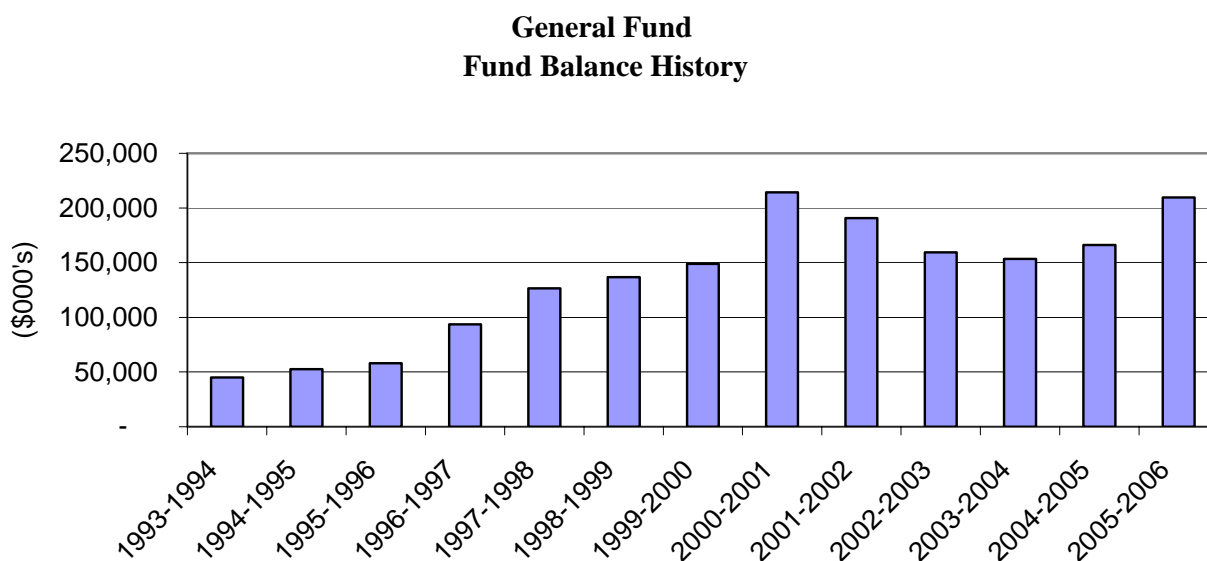
General Fund expenditures of \$741.9 million increased 7.1% (\$49.3 million) when compared to the prior year expenditure level of \$692.5 million. This growth level is also inflated due to the expenditures associated with the FMC purchase and the Coyote Valley Specific Plan. When adjusted for those items, a more accurate depiction of comparable year to year expenditures would show growth of approximately 2.9%. Expenditure growth would obviously have been significantly higher, if not for both the reductions in the budget approved for 2005-2006 and the savings achieved by the strong efforts adopted by the City to contain costs to the extent possible in the face of continuing budget deficits. In fact, it is worth noting that even with extensive 2005-2006 budget reductions, and a concerted effort to keep costs down during the year, General Fund personal services expenditures still grew by 2.1% or \$10.5 million over the prior year (Table 3).

Table 3
General Fund
Comparison of Year-End Actuals With Prior Year By Expenditure Category
(\$000's)

Category	2004-2005 Actual	2005-2006 Actual	Variance	% Variance
<i>Personal Services</i>	497,637	508,115	10,478	2.1%
<i>Non-Personal/Equipment/Other</i>	81,779	87,085	5,306	6.1%
<i>City-Wide Expenses</i>	88,369	129,767	41,398	31.9%
<i>Capital Contributions</i>	18,622	10,465	(8,157)	(77.9%)
<i>Transfers</i>	6,157	6,432	275	4.3%
<i>Reserves</i>	-	-	-	N/A
TOTAL GENERAL FUND	692,564	741,864	49,300	6.6%

As a reflection of the improving economic climate, as well as the success of our budgetary strategies, the year ended with an overall (\$43.4 million) increase in the 2005-2006 Available Ending Fund Balance (\$209.5 million) when compared to the prior year (\$166.1 million). This represents a second year that we have experienced an increase in the fund balance, following four straight years of declines in ending fund balances during the worst of the recessionary years. It should be noted, however, that the increase does not yet bring us back to the dollar level experienced when the fund balance peaked in 2000-2001.

2005-2006 GENERAL FUND PERFORMANCE OVERVIEW (CONT'D.)



ANALYSIS OF 2005-2006 GENERAL FUND OPERATIONS

The following is a summary discussion by category of how the various components of the General Fund budget performed in 2005-2006. A more detailed explanation of the activities in each of these categories can be found later in this document.

Sources of Funds

Overall General Fund sources of funding (revenue plus fund balance) ended the year \$9.3 million (less than 1.0%) below the 2005-2006 Modified Budget level, and \$10.4 million (1.1%) below the estimate used to develop the 2006-2007 Adopted Budget's Beginning Fund Balance component.

On a gross basis, total General Fund revenue collections of \$762.8 million ended the year slightly (1.3% or \$10.0 million) below the 2005-2006 Modified Budget level. After adjusting for grant and reimbursement related revenues that were carried over to 2006-2007, however, the remaining revenue collections actually ended the year slightly above (0.5% or \$3.6 million) the modified budget level. As described above, this performance was the cumulative result of a number of higher and lower than budgeted revenue source performances.

Uses of Funds

Overall, on a gross basis, General Fund uses of funds ended the year \$218.7 million under (down 22.8%) the 2005-2006 Modified Budget level, and \$45.0 million below (down 5.7%) the estimate used to formulate the 2006-2007 Adopted Budget's Beginning Fund Balance

ANALYSIS OF 2005-2006 GENERAL FUND OPERATIONS (CONT'D.)

Uses of Funds (Cont'd.)

component. Most of the savings total, approximately \$173.7 million, was previously estimated to be available by year-end as part of the beginning fund balance estimate that was included in the 2006-2007 Adopted Operating Budget. As discussed above, however, the net additional savings in this category was \$42.5 million. Adjusting for previously discussed grant and reimbursement related appropriations that were rebudgeted to 2005-2006, net expenditures savings actually ended the year \$28.9 million above the budgeted estimate.

As is the standard practice in these Annual Reports, the recommitment of funding through rebudgeting actions is recommended as part of this report to fund uncompleted projects and to allocate development-related expenditure savings to the appropriate development-related activities. A more detailed discussion of the significant specific rebudget amounts is provided in the General Fund Expenditure Performance section found later in this document. After accounting for these additional recommended rebudgets, including reserves, net expenditure savings of approximately \$6.4 million was realized, primarily from personal services, non-personal/equipment, and capital project savings.

The 2005-2006 General Fund Contingency Reserve ended the year at \$23.3 million. This was 6.4% below (\$1.6 million) the 2004-2005 year-end level of \$24.9 million. The Contingency Reserve did end the year slightly below the Council policy goal of 3.0% of total budgeted General Fund expenditures (2.7%). During the year the reserve level does often drop below 3.0% if significant additions to the budget or uses of the Contingency Reserve are required. At the beginning of each year, however, the Contingency Reserve is re-established at a level necessary to meet or exceed the City Council's reserve policy level of 3.0% of expenditures. Thus, the 2006-2007 Adopted General Fund Budget was constructed with a 3% reserve. Actions are included in this document to increase the Reserve to maintain the 3% level, in light of the overall increase in the budget resulting from the higher than anticipated fund balance.

Ending Fund Balance

The current budgeting practice of the City is to use the fund balance remaining in the General Fund at the end of any fiscal year, after the establishment of sufficient funding in the Contingency Reserve, as a funding source for the following year. Thus, each year during the budget process, a detailed estimate of the unused balance in the General Fund is incorporated into the Adopted Budget.

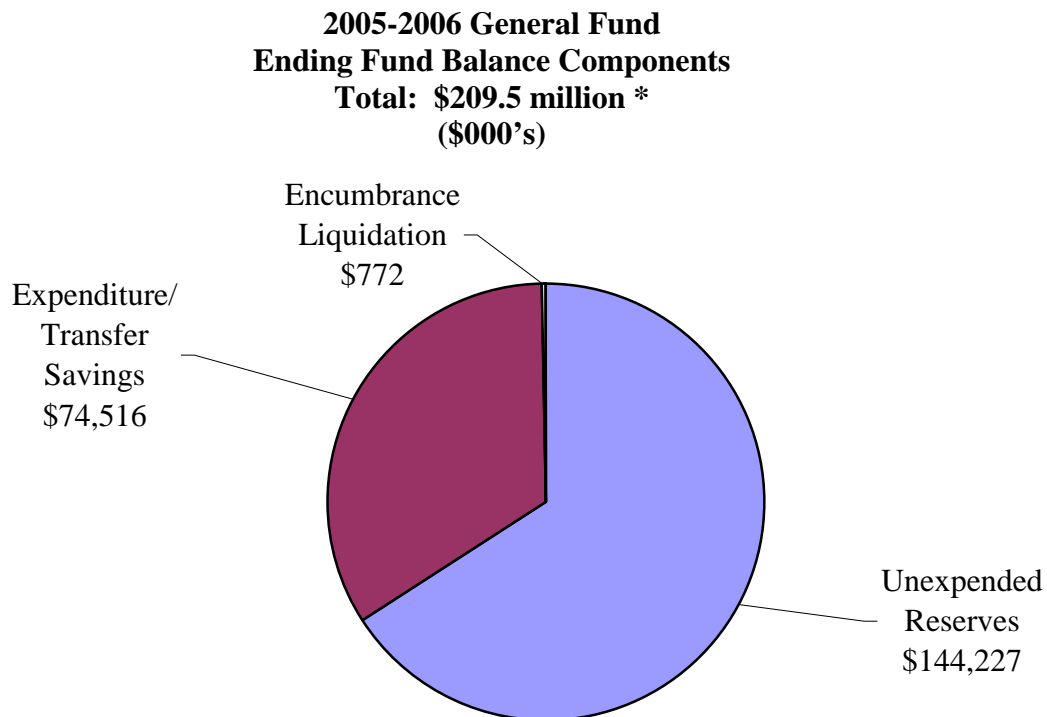
The Ending Fund Balance estimate always contains two components: the portion of the fund balance that needs to be rebudgeted for completing projects or retaining reserves; and that portion which is truly undesignated and available as a funding source in the coming year. The undesignated portion is further divided into ongoing and one-time components to assure that the City does not fund ongoing programs with one-time fund balance monies. The components of ending fund balance in any year are unexpended reserves, expenditure/transfer savings, excess revenue, and liquidated encumbrances.

ANALYSIS OF 2005-2006 GENERAL FUND OPERATIONS (CONT'D.)

Ending Fund Balance (Cont'd.)

When the 2006-2007 Operating Budget was developed, it was estimated that the 2005-2006 ending fund balance would total approximately \$174.9 million. As discussed earlier, the actual ending fund balance of \$209.5 million was \$34.6 million above that estimated level, and \$43.4 million above the prior year level. Although this second year of growth is a step in the right direction, it would be prudent to remember that we have still not recovered from the four prior years that saw a steady reduction of fund balance, totaling over \$60 million, as part of a deliberate budget balancing strategy to minimize the impact on service delivery. In fact, even with the \$43.4 million increase this year in ending fund balance, the City's fund balance is still less than it was in 2000-2001. In light of recent economic reports predicting a slowdown in economic growth, and the ongoing difficult financial environment in which the City operates, it is important for us to continue to follow the cautious financial strategy recommended in this report concerning the commitment of any additional one-time funding that becomes available.

The components of the 2005-2006 General Fund Ending Fund Balance are described below:



* The total of the amounts shown in the above graph (\$219.5 million) were offset with a \$10.0 million shortfall in General Fund revenues, for a net 2005-2006 General Fund Ending Fund Balance of \$209.5 million

- As planned, the largest component of the Ending Fund Balance, unexpended reserves, totaled \$144.2 million, which represents the Contingency Reserve (\$23.3 million), Earmarked Reserves (\$78.6 million), and Ending Fund Balance Reserve (\$42.3 million). The most significant components of the Earmarked Reserves were the following: 2006-2007 Future Deficit Reserve (\$18.4 million); Development-Related Activities Reserves (\$15.3 million);

ANALYSIS OF 2005-2006 GENERAL FUND OPERATIONS (CONT'D.)

Ending Fund Balance (Cont'd.)

Workers' Compensation Reserve (\$10.0 million); Enhanced Park Maintenance Reserve (\$6.9 million); and Future Capital Projects (FF&E) Reserve (\$5.3 million). When the 2006-2007 Budget was developed an Ending Fund Balance Reserve of \$40.2 million was assumed as available for allocation as part of the 2006-2007 Available Beginning Fund Balance. As part of the year-end clean-up actions, however, this reserve was increased to \$42.3 million.

- Expenditure/Transfer savings totaled \$74.5 million. After adjusting for grant and reimbursement related expenditures that were rebudgeted to 2006-2007 (\$13.6 million), however, expenditures actually ended the year at \$60.9 million below the modified budget level. (A corresponding revenue shortfall was also realized and carried over to 2006-2007 for a net zero impact on the General Fund.) A large portion of these savings (\$32.0 million), were rebudgeted as part of the 2006-2007 Adopted Budget for completion of 2005-2006 programs. Additional expenditure/transfer rebudgets and technical adjustments totaling \$15.0 million are recommended as part of this report.
- Total revenues plus fund balance resulted in a shortfall of \$10.0 million. As stated previously however, after adjusting for grant and reimbursement related revenues that were carried over to 2006-2007 (\$13.6 million), the remaining revenue collections actually ended the year slightly above (0.5% or \$3.6 million) the modified budget level. (As discussed above, corresponding expenditure savings were also achieved and rebudgeted to 2006-2007 for a net zero impact on the General Fund.)
- The final component of the Ending Fund Balance is the value of the liquidation of carryover encumbrances, which in 2005-2006 totaled \$772,000. Actual liquidations ended the year slightly below the \$1.0 million level assumed in the 2005-2006 Adopted Budget.

IMPACTS ON THE 2006-2007 ADOPTED BUDGET

Beginning Fund Balance

With the City's current budget practice, ending fund balance amounts carried into the next fiscal year as beginning fund balance is a significant source of one-time funding for the budget. As described previously, the actual General Fund ending balance was above the estimate used in the 2006-2007 Adopted Budget by \$34.6 million. Including Earmarked Reserves, a total of \$28.2 million of this amount is recommended to be rebudgeted and/or utilized to correct problems discovered with the Adopted Budget (described in more detail below). Per City Council policy, the remaining \$6.4 million is recommended to be allocated to a 2007-2008 Future Deficit Reserve.

The following chart details the recommendation included in this document for use of the \$34.6 million additional fund balance:

IMPACTS ON THE 2006-2007 ADOPTED BUDGET (CONT'D.)

Beginning Fund Balance (Cont'd.)

PROPOSED ALLOCATION OF ADDITIONAL FUND BALANCE (\$000s)

Fund Balance Variance	\$ 34,596
Changes to Fee Reserves	3,047
Rebudgets/Technical Adjustments	11,978
Required/Recommended Current Year Adjustments	13,134
2007-2008 Future Deficit Reserve	6,437
Fund Balance After Recommended Adjustments	\$ 0

- **Changes to Fee Reserves (\$3.0 million)** – Consistent with the budget policy enacted several years ago and our commitment to the development community, a net \$3.0 million is recommended to be added to the Development Program Fee Reserves (Building, Planning, Fire, and Public Works), preserving all expenditure savings and/or revenue excess in these programs.
- **Rebudgets/Technical Adjustments (\$12.0 million)** – As discussed above, this series of adjustments are recommended to complete existing projects in 2006-2007 and to reflect any necessary technical budget adjustments. The Annual Report is the point in the budget process where action is required to provide for the rebudgeting of year-end savings not anticipated when the Adopted Budget was approved, but required to complete a significant City Council approved project. Also recommended are a few actions that actually reduce previous rebudgets in various departments, Capital Contributions, and the City-Wide Expenses category, to reflect instances where greater than expected expenditures occurred in 2005-2006 and previously rebudgeted funds are, therefore, not needed in the current year. A net total of \$12.0 million of Rebudgets/Technical Adjustments are identified in this report that need to be carried to the 2006-2007 fiscal year in order to complete the specific projects and programs. The three largest components of this rebudget/technical adjustment recommendation are a transfer of excess Construction and Conveyance Tax revenue to the Park Maintenance Reserve (\$2.9 million) as required by current Council policy; Capital Contributions (\$2.4 million); and City-Wide Expenses (\$1.3 million).

With this action the Park Maintenance Reserve, funded by Council policy through transfer of 15% of Parks Construction and Conveyance Tax proceeds will total \$8.8 million. The City is in the second year of an approved budget action, first approved for the 2005-2006 fiscal year, to transfer \$1.0 million per year of this reserve to the General Fund to help mitigate the need for additional reductions to Parks maintenance services. Because of the unexpectedly high level of collections of the C&C tax for the last two years, this reserve has grown back to a higher than anticipated level. As a result, we intend to bring forward a proposal for Council consideration later in the year to utilize an additional portion of this reserve to potentially restore, at least temporarily, some of the most severe of the parks maintenance service cuts.

IMPACTS ON THE 2006-2007 ADOPTED BUDGET (CONT'D.)

Beginning Fund Balance (Cont'd.)

- **Required/Recommended Current Year Adjustments (\$13.1 million)** – A number of General Fund budget additions are recommended to address current year funding needs that have emerged since the 2006-2007 budget was approved. These adjustments can be classified under three categories: Previous Council Direction; Required Adjustments; and City Manager Initiatives. The following augmentations are recommended and explained in more detail elsewhere in this document:

Previous Council Direction

- the provision of funding for potential additional testing and site remediation for Watson Park (\$5.0 million);
- the provision of funds for City Hall retail space tenant improvements (\$500,000);
- funding to provide for Old City Hall remaining information systems migration preparation work (net \$374,000);
- transfer of proceeds from the sale of surplus property to the Economic Uncertainty Reserve as directed by the City Council policy (\$288,000);
- funding for a transfer from the General Fund to the Muni Water Fund to reflect actual rate of return calculations that were less than the original estimate included in the 2005-2006 Adopted Budget (\$193,000);
- funding to set aside an amount to cover any possible refund that might result from an audit of Comcast's franchise payments over the past four years and additional funding for Comcast negotiation consulting help (\$125,000);
- funding for Transportation Department Annexation and Infrastructure needs assessment (\$120,000);
- funding for recruitment of a new City Manager (\$50,000);
- additional funding for City Hall Re-use Project consulting (\$50,000);
- a transfer to the San José Redevelopment Agency to provide the City's share of funding for the 2006 Mariachi Festival (\$50,000);
- funding to provide for consultant help in developing the Police Staffing Plan (\$25,000);

Required Adjustments

- the provision of additional funding to be distributed to the primary departmental consumers of fuel due to the volatility of fuel prices (\$750,000);
- the provision of funds to purchase the state of the art sound system at the Center for Performing Arts, currently owned by an outside party (American Musical Theatre) who intends to sell the system this year, either to the City or another purchaser (\$470,000);
- the provision of funds for installation of a flaring system at Singleton Landfill (\$250,000);
- funding for Hayes Mansion parking garage repairs (\$205,000);

IMPACTS ON THE 2006-2007 ADOPTED BUDGET (CONT'D.)

Beginning Fund Balance (Cont'd.)

Required Adjustments (Cont'd.)

- a technical adjustment to appropriate the City-side of net maintenance costs for the FMC land (\$125,000);
- a technical adjustment to provide funding to reimburse the Office of Economic Development for advance payments on the purchase of the FMC land (\$73,000);
- funding to the Transportation Department to provide interim parking for Arena employees and City vehicles (\$72,000);
- funding to provide for Fire/Paramedic continuing education vouchers (\$20,000);
- other net-zero adjustments to reflect the revenues and expenditures for grant and reimbursement type activity such as: Senior Staff Home Loan to the San José Redevelopment Agency Director (\$250,000); loan from the San José Redevelopment Agency of a Development Specialist for the Strong Neighborhoods Initiative (\$115,000); a limit dated Program Performance Auditor I position for RDA audits (\$100,000), a grant from Happy Hollow Corporation (\$99,000), and a State Alcohol Beverage Control Grant (\$17,000). A more complete listing of the net-zero adjustments can be found in section III of this document.

City Manager Initiatives

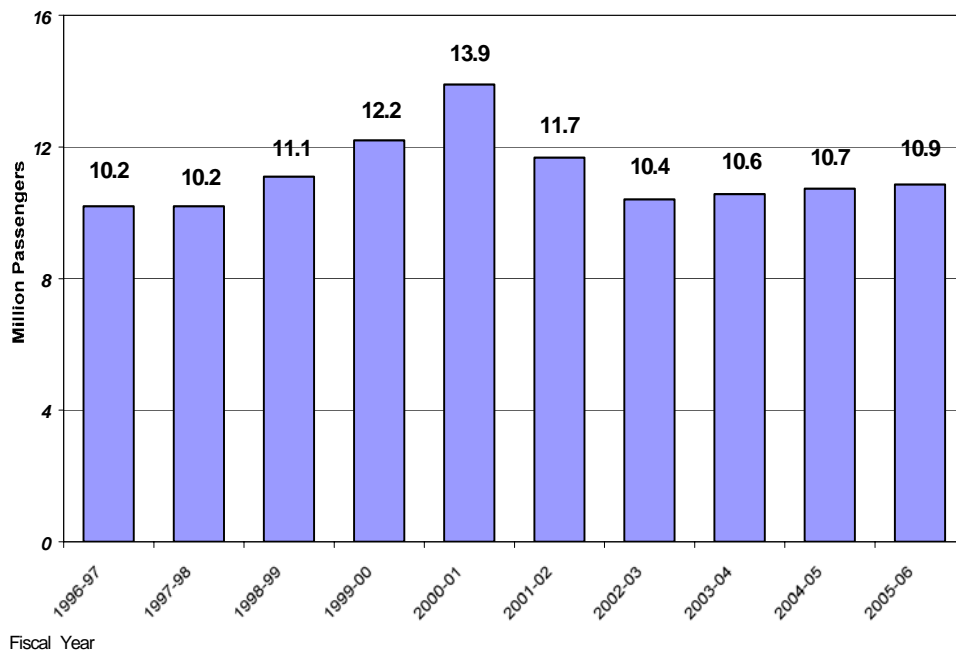
- the provision of funding to provide for the creation of an Arts Stabilization Fund (\$4.0 million);
 - additional funding to Human Resources to provide for an overstrength Senior Analyst position to support the Return to Work Program for the remainder of the fiscal year (\$110,000);
 - funding to the Public Works Department for an overstrength Senior Analyst for ten months to enhance Equality Assurance activity (\$100,000);
 - funding to enable the Human Resources Department to provide for accelerated recruitment efforts (\$90,000);
 - funding to the City Manager's Office to fund the City's share of a joint City-Redevelopment Agency initiative to raise the City's visibility nationally and internationally, to be brought to Council for approval in early October (\$50,000);
 - funding at the request of the Independent Police Auditor to recruit for an Independent Police Auditor Deputy Director (\$25,000); and
 - funding at the request of the City Clerk to recruit for an Assistant City Clerk (\$20,000);
- **2007-2008 Future Deficit Reserve (\$6.4 million)** – After the above actions, per City Council policy, the remaining \$6.4 million in unallocated funds is recommended to be used to establish a 2007-2008 Future Deficit Reserve. Doing so will help prepare the organization to address what is projected be another challenging, upcoming budget year, and is consistent with the fiscally conservative approach that has served the City so well up to this point.

STATUS OF SPECIAL/CAPITAL FUNDS

Airport Operating Funds

The Airport served approximately 10.9 million passengers in 2005-2006 but passenger activity levels increased by only 1.2% as compared to the prior year. There still is no sign of a significant resumption of passenger growth from the severe level of falloffs following 9-11. Recent new services were, however, introduced at the Airport include the addition of Hawaiian Air, with a daily non-stop flight to Honolulu Airport. Additionally, Mexicana Airlines initiated non-stop flight service to Mexico City. All other activity including parking exits, pounds of mail/freight/cargo, traffic operations, landed weights and gallons of AV fuel however experienced slight declines in comparison to the prior fiscal year.

**Norman Y. Mineta San José International Airport
Passenger Activity**



Overall, however, reflecting conservative estimates, Airport operating revenues ended the year slightly above (2.1%) budgeted levels. Revenue in all categories, including Airfield Area, Landing Fees, Terminal Building, Terminal Rental, and Petroleum Products, was greater than the modified budget except in Parking and Roadway. The Airport continued its practice of setting service priorities, establishing savings targets and closely monitoring all expenditures in an effort to maintain customer service levels while controlling operating expenses. The Airport set a target to save a total of \$2.2 million in direct personal services and non-personal/equipment expenses during 2005-2006. The savings target was exceeded by over \$2.7 million. In addition, conservative management of transfers, reserves and contingencies and prior year liquidations provided an additional \$1.6 million in operating savings. These actions contributed to higher than anticipated fund balances in the Airport funds at year-end.

STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

Convention and Cultural Affairs Fund

The Convention and Cultural Affairs Fund accounts for the operation of the City's Convention Facilities that are managed by Team San José. In 2005-2006, activity at the Convention Facilities generated higher than anticipated revenues. The actual revenue collections were \$193,000 above the budgeted level due to higher than anticipated space rental and concessionary income (\$230,000) offset by lower than estimated interest earnings.

Total expenditures in this fund, however, exceeded the modified budget by \$192,000 due to an overage of \$517,000 in the non-personal/equipment appropriation, partially offset by savings in personal services. The overage in the non-personal/equipment appropriation occurred due to additional contractual employees and a higher than previously estimated Accounts Payable balance. This overage was entirely offset by City Council ratification of a transfer of the savings from the personal services appropriation and the receipt of additional Team San José revenue collections over budget in 2005-2006. As a result of these actions, the fund ended 2005-2006 with a \$289,000 increase to ending fund balance.

Also as part of this document, \$512,000 of additional 2005-2006 Transient Occupancy Tax Revenue is being transferred to this fund. A portion of these funds (\$250,000) are recommended to be added to the Miscellaneous Improvement appropriation for three urgent capital projects: Convention Center Cooling Tower Repairs (\$100,000), Parkside Hall Floor Replacement (\$100,000) and a Convention Center Building Assessment (\$50,000).

Stores Fund

The Stores Fund accounts for the purchase and issuance of materials and supplies consumed by departments for general operations. At the end of 2005-2006, revenues were 18.4% (\$813,000) below budgeted levels, reflecting lower than budgeted activities in the Fund. Expenditures were 20.9% (\$950,000) below anticipated levels due to the implementation of expenditure control measures and lower than estimated inventory purchases. Expenditure savings were also realized from lower than anticipated personal and non-personal costs.

Included in this report is a recommendation for an increase of \$600,000 for postage expenditures and a corresponding increase of \$600,000 in revenues to account for city-wide postage expenses that were inadvertently omitted in the development of the 2006-2007 Adopted Budget.

STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

Transient Occupancy Tax Fund

Due to much higher than expected receipts in the last half of the fiscal year, actual 2005-2006 revenues in the TOT Fund exceeded the budgeted amount by almost \$2 million. Although there was no significant increase in the number of rooms, the average room rate increased during last year from \$114 to \$120, and the occupancy rate increased to 57.7% from 48.9% in the prior year.

Transient Occupancy Tax Fund tax revenue growth is by ordinance shared by three groups, the Convention Center Operation Subsidy (50%), the Convention Visitors Bureau (25%) and Cultural Grants (25%). This report, therefore, contains the proposed appropriation adjustment actions required to distribute the excess collections to the three groups, (net of funds rebudgeted as part of the 2006-2007 Adopted Budget). An increase of \$512,000 is recommended for the Convention Facilities Operation Subsidy. An increase of \$256,000 is recommended for the Convention and Visitor Bureau and \$256,000 to the Cultural Grants.

Capital Improvement Program Funds

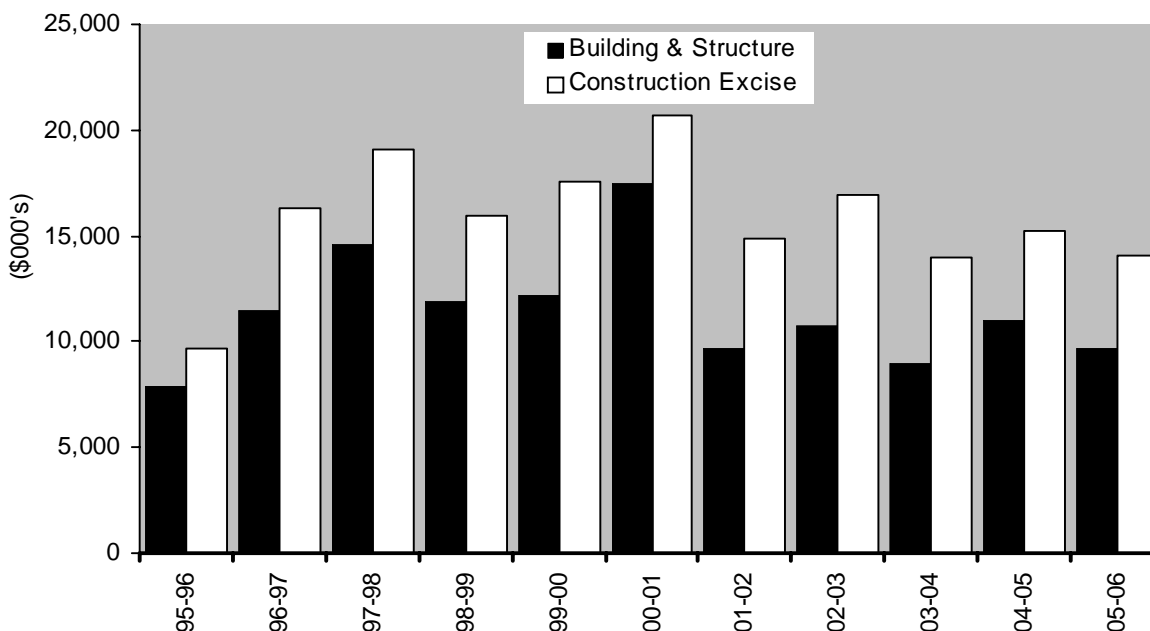
As reported in Monthly Financial Reports during the year, 2005-2006 collections in several of the major capital tax revenue categories exceeded the estimates included in the modified budget. Year-end collections in the Building and Structure Construction Tax category totaled \$9.7 million, which was approximately \$1 million above the modified budget estimate of \$8.7 million, but \$1.3 million (12%) below the 2004-2005 collection level of \$11.0 million. The 2005-2006 collections were, however, above the 2003-2004 receipts of \$9.0 million. With a similar trend, Construction Excise Tax receipts of \$14.1 million exceeded the modified budget estimate of \$13.4 million by \$700,000, but fell \$1.2 million (7.8%) below the 2004-2005 collection level of \$15.3 million. The 2005-2006 level of activity was approximately consistent with 2003-2004 levels in which \$14.0 million was received.

The following graph displays the collection history of both the Building and Structure and Construction Excise Tax receipts over the past decade and illustrates the dramatic growth during the latter part of the 1990's. While collections have fallen from the peak in 2000-2001, they have remained relatively strong when considering the historical performance of these taxes.

STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

Capital Improvement Program Funds (Cont'd.)

Construction Tax Revenues



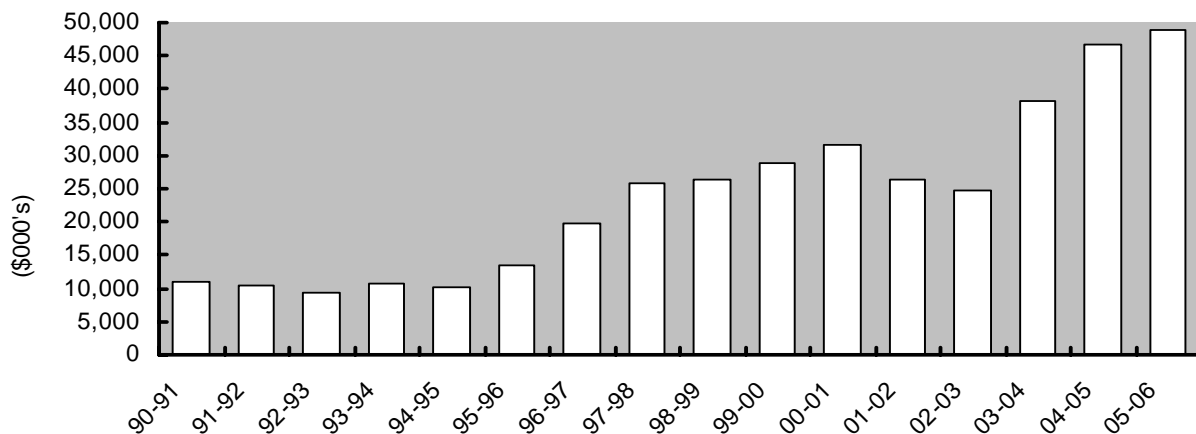
Construction and Conveyance Tax revenues, which are a significant source of funds for the Parks and Community Facilities Development, Library, Fire, Service Yards, and Communications capital programs, experienced growth of 5.0% in 2005-2006. Actual receipts totaled \$49.0 million, exceeding both the revised budget estimate of \$44 million and the 2004-2005 collection level of \$46.7 million. Collections in this category have been extraordinarily high in the last three years, with growth of almost 100% over this period due to the strength of the real estate market. The growth in the last three years was realized after two years of declines in 2001-2002 and 2002-2003. When the 2005-2006 budget was developed, it was assumed that there would be a slowdown in the real estate market that would result in lower revenue collections. While receipts did start to drop at the end of the fiscal year, strong collections through the first half of the year resulted in higher overall collections. It should be noted, however, that home prices are no longer showing the tremendous growth that has been experienced over the last several years. The single-family median home price of \$740,000 as of June 2006 was 4.8% above the June 2005 figure of \$706,000. When reviewing the home prices in the last few years, these figures are still significantly higher than the June 2004 median home price of \$585,000 and the June 2003 figure of \$511,000. While the median home price has remained high, the number of real estate transactions has started to drop with an overall decline of 18% in 2005-2006. This includes a 12% decline in the number of sales in the first half of the year followed by a 25% decline in the second half of the year. The amount of time it takes to sell a home has also increased. The average days on market has increased from 15 days in June 2005 to 34 days in June 2006.

STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

Capital Improvement Program Funds (Cont'd.)

The following graph displays the collection history of Construction and Conveyance Tax receipts. As can be seen, during the recession years in the early 1990s collections hovered around the \$9-11 million level for approximately five years. Following that recession, collections surged, with receipts reaching \$31.6 million in 2000-2001. After reaching this peak, collections dropped in both 2001-2002 and 2002-2003. The unprecedented growth of 54% in 2003-2004 followed by additional 22% growth in 2004-2005 and 5% growth in 2005-2006 ended this downward trend. Given the economic health of the region, the level of growth over the past three years has been extremely surprising and makes it very difficult to predict the level of activity in 2006-2007. We do believe however, that the housing market will continue to soften, impacting receipts in this category. A slowdown in the real estate market has also been a major theme of the California forecast produced by the prestigious UCLA Anderson Business School. Even given this risk, with the higher than anticipated level of 2005-2006 collections, the 2006-2007 Adopted Budget estimate of \$27.0 million is likely a conservative one, allowing a drop of 45% from the actual 2005-2006 collection level. Staff will closely monitor receipts in this area to determine if this revenue category can be adjusted upwards during the year.

Construction and Conveyance Tax Revenues



Airport Capital Funds

Major projects with expenditures and encumbrances in 2005-2006 include the North Concourse (\$52.5 million), Taxiway Y Reconstruction (\$26.9 million), Noise Attenuation (\$25.2 million), Utility Infrastructure (\$5.6 million); and FMC Site Reuse Preparation (\$3.2 million). The North Concourse is expected to be completed by June 2008.

STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

Capital Improvement Program Funds (Cont'd.)

Airport Capital Funds (Cont'd.)

The Airport Capital Program was also significantly restructured in 2005-2006. In September 2005, a three-day workshop with airline representatives, City staff, and industry consultants was held to review implementation plans for the Airport capital development program and to help formulate recommendations to better align Airport development with current economic assumptions. This workshop resulted in two key findings: airport passenger demand volume originally projected for the year 2010 (17.6 million) is now not projected to be reached until the year 2017; and in order to retain reasonable rates and charges, the Master Plan needs to be limited to \$1.2 - \$1.5 billion. On November 15, 2005, the City Council conceptually approved revisions to the implementation of the Airport Master Plan downsizing the scope of the project based on these findings. The 2007-2011 Adopted Capital Improvement Program incorporates these changes.

Public Safety, Library, and Parks and Community Facilities General Obligation Bond Funds

Major improvements continue in the City's parks, community centers, libraries and public safety facilities as a result of voter-approved bond measures that will generate a total of \$599 million for these purposes. In 2005-2006, \$107.2 million was expended or encumbered in the Public Safety (\$34.7 million), Library (\$45.5 million), and Parks and Community Facility (\$27.0 million) General Obligation Bond Funds.

In the Public Safety Program, the projects with the largest expenditures and encumbrances included the following: South San José Police Substation (\$13.1 million); Fire Station 34-Berryessa (\$5.7 million); Fire Station 35-Cottle/Poughkeepsie (\$5.5 million); Fire Station 25-Alviso (\$4.4 million); and Fire Station Upgrades (\$1.6 million). In 2005-2006, several projects were completed including upgrades to fire stations 9, 14, 11, 15; the West Community Policing Center; and emergency generators for fire stations 4, 13, and 26. In addition, the land was acquired for the South San José Police Substation and the construction contracts were awarded for Fire Stations 25, 34, and 35.

In the Library Program, the projects with the largest expenditures and encumbrances in 2005-2006 included the following: Cambrian Branch Library (\$8.9 million); Edenvale Branch Library (\$8.4 million); Hillview Branch Library (\$8.2 million); Evergreen Branch Library (\$6.1 million); Almaden Branch Library (\$3.1 million); Rose Garden Branch Library (\$2.6 million); Joyce Ellington Branch (\$1.1 million); the Santa Teresa Branch (\$1.1 million); and the Dr. Roberto Cruz Alum Rock Branch (\$1.1 million). In 2005-2006, the Dr. Roberto Cruz Alum Rock Branch Library, the Rose Garden Branch Library, and the Almaden Community Center and Branch Library were completed.

STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

Capital Improvement Program Funds (Cont'd.)

Public Safety, Library, and Parks and Community Facilities General Obligation Bond Funds (Cont'd.)

In the Parks and Community Facilities Program, the projects with the largest expenditures and encumbrances included the following: Happy Hollow Park and Zoo Renovation (\$6.4 million); Almaden Community Center (\$6.3 million); Roosevelt Community Center (\$3.7 million); Los Gatos Creek Trail (\$1.7 million); Morrill Community Center (\$1.5 million); and Emma Prusch Memorial Park (\$1.4 million). In 2005-2006, several projects were completed including the Almaden Community Center and Branch Library, the Southside Community Center, the Morrill (Berryessa) Community Youth Center, the Camden Community Center Improvements, the Selma Olinder Park Restroom, and the San Tomas Aquino/Saratoga Creek Trail Reach 6.

Traffic Capital Program Funds

In 2005-2006, a total of \$69.4 million was spent or encumbered for traffic capital projects. The projects with the largest expenditures and encumbrances included Street Maintenance (\$5.4 million); Traffic Signals (\$4.2 million); Bailey Avenue Extension (\$2.9 million); Oakland Road: Route 101 to Montague (\$2.7 million); Lucretia Avenue: Story to Phelan (\$2.0 million); Traffic Signals Rehabilitation (\$1.9 million); Route 880: Coleman Interchange (\$1.9 million); Route 880: Stevens Creek Interchange (\$1.7 million); and Quito Road: Saratoga to Bucknall (\$1.1 million). Projects completed in 2005-2006 include Bailey Extension Segment C – Bailey Overcrossing @ Monterey Road; King/Story Road Street and Sidewalk Improvements; Story Road Widening – Senter Road to McLaughlin Avenue; Towers Lane; Traffic Signal at Harris Avenue and Leigh Avenue, and Traffic Signals LED Conversion.

Many Strong Neighborhoods Initiative projects were also completed, including the Couplet Conversion - 3rd/4th Street from Julian to Jackson in the Thirteenth Street Strong Neighborhood; West San Carlos Streetscape Enhancements in the Delmas Park Strong Neighborhood; McLaughlin Avenue and William Street Improvements in the Five Wounds Strong Neighborhood, Bulb Outs – 10th and Martha Streets and 11th and Martha Streets in the Spartan Keyes Strong Neighborhood; Historic Streetlights in the University Strong Neighborhood; Traffic Signal at King Road and Wilshire Boulevard in the Gateway East Strong Neighborhood; West Virginia and Delmas Avenue Streetscapes in the Greater Gardner Strong Neighborhood; and Enhanced Crosswalk – Aborn Road and Irwindale Drive in the West Evergreen Strong Neighborhood.

STATUS OF SPECIAL/CAPITAL FUNDS (CONT'D.)

Capital Improvement Program Funds (Cont'd.)

Recommended Capital Budget Actions

In addition to the fund balance reconciliations completed for every fund and the numerous rebudget adjustments to properly account for project costs, there are a number of budget actions recommended in this report. The largest increase is in the Airport Capital Program. An additional \$30 million is recommended for the completion of design and construction of an In-Line Baggage Screening Facility at Terminal A that was not a sub-project included in the original Terminal Area Improvement Program appropriation. This facility will replace the temporary pods in Terminal A, which are very labor intensive and expensive for the airlines to operate. Other Airport projects recommended include: Runway Latent Defects (\$250,000 – to correct latent defects in the painting of runway markings); Customer Service Enhancements (\$330,000 – flight information displays in Terminal A); and Advanced Planning (\$50,000 – Obstruction Study).

In the Traffic Capital Program, new TCRP State revenue of \$6.9 million, contained in the final State Budget, is recommended to be recognized and allocated to street maintenance. Other additions in this program include a new Regional Project Right-of-Way Support project (\$455,000) to closeout the land transactions associated with a number of regional interchange projects, and a new Curtner Avenue Widening Project (\$640,000) to widen Curtner Avenue at Monterey Highway to coincide with the development of the old GE site. When the 2006-2007 budget was developed, it was assumed that this project would start in 2005-2006.

In the Parks Capital Program, there are a series of adjustments to address needs or reallocate funding. In the Park Trust Fund, the following projects are being adjusted: Reserve: East San Jose Park/Facilities Development (\$539,000 – offset by a reduction to the Reserve: PAL Restroom ADA Retrofit); Calabazas Park Improvements (\$50,000); Canyon Creek Park Perimeter Improvements (\$43,000); Watson Park Master Plan (36,000 – offset by a reduction in the Reserve: Watson Park Master Plan); Plata Arroyo Improvements (\$13,000); and eliminate the Reserve: McKee Parksite Acquisition (\$781,000). In the Construction and Conveyance Tax Funds, the following actions are recommended: Calabazas Park Improvements (District 1 - \$40,000); Overfelt Amphitheatre Minor Improvements (District 5 - \$30,000); Tully Road Ballfields Parking Lot Improvements (District 7 - \$12,000); Samaritan Turnkey Park (District 9 - \$200,000); and Happy Hollow Park and Zoo (City-Wide - \$600,000 advanced from 2007-2008.)

LOOKING AHEAD

Although San José and the surrounding areas may continue to lag behind the rest of the State and the nation in terms of economic recovery, the results for the 2005-2006 fiscal year indicate that we have successfully emerged from a period of severe declines in economic growth and have returned, at least for the present, to more historically moderate growth levels. Due to the modest recovery in the economy combined with the very real efforts of City employees to reduce costs by doing more with less, the City successfully managed 2005-2006 budgetary challenges, and

LOOKING AHEAD (CONT'D.)

ended the year in a sound financial position. No one should think that we are out of the woods yet, however, as even with this resumption of moderate revenue growth levels, all of our recent forecasts have consistently indicated that we will still face budget deficits for at least the next several years.

During these times of economic uncertainty, my brief time back with the organization has also made very clear to me that there are a number of major challenges that have gone unaddressed or have been given inadequate attention in recent years, understandably so, as so much energy was focused on simply surviving financially. But now, as we move into a new phase of future planning, these topics should be considered carefully and collectively as the City evaluates options during the budget process over the next several years. The most important of these topics in my view include:

- **“Greater Financial Oversight”** – In order to confirm the “greater financial oversight” concept approved by the City Council on September 19, 2006, including bringing the Monthly Financial Reports back to the City Council Committee level, it has been recommended that the Monthly Financial Report be presented to the Making Government Work Better Committee on a bi-monthly basis. I strongly support that direction and propose the following reporting schedule:

MFR Reporting Period	MGWB Committee Date
July/August MFR	October
September/October MFR	December
November/December MFR	No Committee-Mid-Year Budget Review (February)
January/February MFR	April
March/April MFR	June
May/June MFR	No Committee-Annual Report (October)

The MGWB Committee already has on its workplan the Quarterly Investment Report and Quarterly Debt Report.

- **Unmet City Infrastructure Needs** - Critical unmet City infrastructure needs continue to exist and there is an ongoing need to earmark additional funding to address the backlog of capital replacement and maintenance needs that are not funded. The Adopted Budget included a start on the backlog with \$9.8 million budgeted for:
 - 1) **Transportation Infrastructure Maintenance Backlog** - \$5.3 million – to address street resurfacing, transportation safety enhancements, and improved neighborhood appearance. However, a report to the Building Better Transportation Committee estimated a \$370 million need for one-time infrastructure rehabilitation and capital improvement to our surface transportation system. Even with the passage of State transportation bonds, the ongoing annual pavement maintenance shortfall is projected between \$10 million and \$14 million over the next five years.

LOOKING AHEAD (CONT'D.)

- 2) Technology - \$3.5 million – to begin to address the City's most critical technology needs (specific recommendations to be brought forward at a later date). The City, however, has no replacement program funding for personal computers (annual cost estimated to be \$2.2 million), servers, or updating software. This absence of a planned funding program will become an acute problem in the future if the City does not start to address it now.
- 3) Facilities Infrastructure Maintenance Backlog - \$1.0 million – to address the fact that our infrastructure asset inventory has grown in the last five years with resources not keeping pace, resulting in our infrastructure condition continuing to decline – examples of improvements needed include structural, electrical, mechanical and roofing repairs. The City also has millions of dollars in unfunded cultural facilities infrastructure needs which is currently being reviewed and prioritized.

As we move to address these unmet needs, one funding source that we will be examining will be the potential use of a portion of a reserve, the Measure O/P FF&E Reserve, set aside a number of years ago, primarily to address future one-time Furniture, Fixtures and Equipment (FF&E) needs of bond funded capital projects. This reserve remains basically untouched, currently totaling approximately \$6.8 million. Although a number of bond projects remain unfinished and a portion of this reserve, therefore, may be needed for its original purpose, it may be prudent to utilize a portion of this reserve for the most critical unfunded infrastructure needs.

- **Police Staffing Plan and Restoration of Critical City Core Services** – As we analyze the Council-directed five-year forecast for police staffing and continue with our commitment to public safety services, we cannot ignore the five-year forecast for other operations that support police and fire services (i.e., an effective Police Department needs an effective Parks, Recreation, and Neighborhood Services Department, Human Resources Department, Information Technology Department, etc.) The budget situation over the last five years has required many reductions to basic City services. We need to review the reductions that have caused the most serious service level impacts for possible restoration over the next several years particularly if we are going to continue to add new capital facilities -- a virtual certainty in view of remaining capital bond funds and community expectations that have not diminished.
- **Operations and Maintenance of Capital Projects** – The large number of new and expanded facilities funded from our Bond Programs and Redevelopment Agency are continuing to come on-line. Funding of over \$4 million was included in the 2006-2007 Operating Budget to operate new parks, library and public safety facilities, as well as for traffic projects that are scheduled to be operational this year. Our five-year forecast indicates that this level of investment will need to increase significantly over the next several years as the remaining bond-funded parks, library, and public safety facilities come on-line. For example, it is estimated that the General Fund operating costs for these facilities will total \$7.6 million in 2007-2008 and climb to \$26.7 million by 2010-2011. For example, we must reconcile the logic of adding major new community centers while planning for the reuse of existing community centers.

LOOKING AHEAD (CONT'D.)

- **Fine Arts Groups/Community-Based Organizations Fiscal Management** - We must be more proactive in the fiscal management of the City's non-profit organizations, including Fine Arts Groups and Community-Based Organizations. As the City Council is aware, we have a number of Arts groups that have recently approached the City for major financial assistance and others are likely to follow. The City needs to determine how much assistance it can provide to organizations in financial difficulty. To establish an early warning system, we also need to dedicate resources to the ongoing review and evaluation of financial information and establishing performance standards for our non-profits. To help address this issue we have recommended in this report the use of a portion of the available General Fund Balance dollars to establish a \$4.0 million Arts Stabilization Fund.
- **Rising Employee Benefit Costs** - We must continue our efforts to manage rising employee benefit costs. Currently, the City, active employees and retirees pay \$76 million per year in health insurance premiums. The cost of retiree health care is currently being studied by the actuaries of both of the City's retirement boards in light of the Governmental Accounting Standards Board (GASB) new requirements. In addition, the City's contributions to the retirement plans continue to increase. During this fiscal year, the City is expected to contribute \$120 million to both plans. Another significant cost factor is Workers' Compensation costs, which are budgeted this fiscal year to be \$17 million in the General Fund alone. We have made progress in these areas, but we need to continue our efforts, in partnership with the City's bargaining units, to contain or reduce these ongoing employee benefit costs.
- **City Administrative Project System (CAPS) Database** – Under separate cover, the first report on the new City Administrative Project System (CAPS) Database will be released later in the week. This new database is a compilation of all major projects and initiatives that the Administration has undertaken, not including base service delivery items as well as capital improvement projects. The system was launched in early September and will be used to improve tracking and monitoring of the many citywide projects, to ensure accountability, and will also serve as a backdrop/priority list for assessing new assignments to departments directed by the City Manager, Council Committees, and the City Council. It is recommended that the City Council and staff use this system to weigh and consider any new projects and assignments in the context of these current projects and determine which projects may need to be considered for deferral or dropped. This will be essential if we are to control staffing needs and ensure that the work that has already been directed to be done, in fact, gets done.

On an overall basis, however, this report confirms that this organization can be justly proud of the fact that it has been able to maintain the most essential City services and programs in the face of ever shrinking resources. Again, it is a testament to the Mayor and City Council's leadership and steadfast commitment to sound fiscal planning that the City remains in a strong and relatively enviable financial position. I am very confident that it will be this same leadership, along with the combined dedication of policymakers and administration that will help us manage successfully through any difficult times that lie ahead and allow us to cope with developing strategies to achieve the long-term fiscal health of the City while still meeting many of the expectations of the Council and community.

LOOKING AHEAD (CONT'D.)

As always, the Administration will continue to monitor the current year closely, reporting the City's fiscal status to the City Council through the Monthly Financial Report and Mid-Year Budget Review process.

Les White
City Manager

HONORABLE MAYOR AND CITY COUNCIL
October 2, 2006

xxvii

October 2, 2006

I hereby certify that there will be available for appropriation in the designated funds and in the amounts as listed below in fiscal year 2006-2007 monies in excess of those heretofore appropriated therefrom:

General Fund	\$ 34,982,721
Airport Capital Improvement	1,388,317
Airport Fiscal Agent	101,986,432
Airport Maintenance and Operations	1,084,050
Airport Passenger Facility Charge	9,238,404
Airport Renew & Replacement	1,240,626
Airport Revenue	5,129,992
Airport Revenue Bond Improvement	132,480,599
Airport Surplus Revenue	690,000
Anti-Tobacco Master Settlement Agreement	595,966
Building & Structure Construction Tax	5,673,583
Business Improvement District	3,149
Cash Reserve	23
Civic Center Construction	554,100
Civic Center Improvement	944,439
Civic Center Parking	1,908,240
Community Development Block Grant	2,221,138
Community Facilities District 1	49,720
Community Facilities District 2 and District 3	28,177
Community Facilities District 8	281,838
Consolidated Water Utility	37,006
Construction & Conveyance Tax - Council District 1	568,774
Construction & Conveyance Tax - Council District 2	337,877
Construction & Conveyance Tax - Council District 3	1,520,156
Construction & Conveyance Tax - Council District 4	709,110
Construction & Conveyance Tax - Council District 5	357,528
Construction & Conveyance Tax - Council District 6	430,177
Construction & Conveyance Tax - Council District 7	510,888
Construction & Conveyance Tax - Council District 8	284,954
Construction & Conveyance Tax - Council District 9	332,891
Construction & Conveyance Tax - Council District 10	662,204
Construction & Conveyance Tax - Central Fund	780,742
Construction & Conveyance Tax - City-Wide	1,553,301
Construction & Conveyance Tax - Communications	917,419
Construction & Conveyance Tax - Fire	624,781
Construction & Conveyance Tax - Library	1,184,445
Construction & Conveyance Tax - Parks Maintenance	272,543
Construction Excise Tax	21,474,307
Convention & Cultural Affairs	801,100
Dental Insurance	388,526
Development Enhancement	188,135
Economic Development Administration Loan	11,896
Emma Prusch	58,967
Emergency Reserve	18,854
Federal Drug Forfeiture	56,951
Federal Local Law Enforcement Block Grant	16,803
General Purpose Parking	9,474
Gift Trust	205,939
Hayes Mansion Phase III	454,157
Housing Trust	569,183
Ice Centre Revenue	408,181
Integrated Waste Management	386,698

HONORABLE MAYOR AND CITY COUNCIL

xxviii

October 2, 2006

Interim City Facilities Improvement	\$	1,463,508
Lake Cunningham		127,817
Library Benefit Assessment District		88,175
Library Parcel Tax		937,121
Life Insurance		4,990
Low & Moderate Income Housing		7,158,422
Maintenance Assessment District 1		102,682
Maintenance Assessment District 2		22,776
Maintenance Assessment District 5		24,940
Maintenance Assessment District 8		7,558
Maintenance Assessment District 9		4,516
Maintenance Assessment District 10		88,854
Maintenance Assessment District 11		11,004
Maintenance Assessment District 13		12,088
Maintenance Assessment District 15		335,209
Maintenance Assessment District 18		10,211
Maintenance Assessment District 19		29,878
Maintenance Assessment District 20		51,670
Maintenance Assessment District 21		67,394
Maintenance Assessment District 22		53,654
Major Collectors and Arterials		21,279
Multi-Source Housing		83,938
Municipal Health Services Program		217,706
Municipal Golf Course		652,522
Municipal Water & Major Facilities Fee		689,211
Parks & Recreation Bond Project		5,415,365
Redevelopment Agency Capital Projects (City side)		1,913,085
Sanitary Sewer Connection Fee		5,408,251
Sewage Treatment Plant Connection Fee		352,526
Sewer Service & Use Charge		1,877,194
Sewer Service & Use Charge Capital		7,308,441
SJ-SC Treatment Plant Capital		10,290,235
SJ-SC Treatment Plant Income		305,874
State Drug Forfeiture		45,473
Stores		387,404
Storm Drainage Fee		81,913
Storm Sewer Capital		741,044
Storm Sewer Operating		1,889,463
Subdivision Park Trust		7,334,463
Transient Occupancy Tax		1,383,133
Underground Utility		554,501
Unemployment Insurance		187,695
Water Utility Capital		183,936
Vehicle Maintenance & Operations		595,243

Larry D. Lisenbee
Budget Director